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Amazon Continues Shining As We Shop Differently

May 05, 2021 6:22 AM ET | **Amazon.com, Inc. (AMZN)** | 22 Comments | 14 Likes

Summary

- Third-party sales are growing rapidly as no e-commerce marketplace gets products delivered faster than Amazon.
- The overall growth at Amazon is impressive but the lift in advertising is mind boggling.
- The advertising segment is sticky as third-party merchants use ads to feed the Amazon algorithm.

Photo by 400tmax/iStock Unreleased via Getty Images

Introduction

My thesis is that Amazon (AMZN) is thriving as consumers have gotten used to the convenience of shopping online during the Covid pandemic. In the 2020 letter which was his last annual shareholder letter as the CEO of Amazon, Jeff Bezos said that customers complete 28% of purchases on Amazon in three minutes or less. Shopping habits have changed permanently due to Amazon as customers can order items quickly and have them delivered the next day. As vaccines roll out and physical stores start opening back up, many shoppers are not abandoning Amazon.

Working Backwards: Insights, Stories, and Secrets from Inside Amazon by Colin Bryar and Bill Carr talks about the fact that Amazon gets incentives right. They note that long-term equity becomes a bigger part of compensation as folks get promoted and the frugality leadership principle keeps costs under control as there are no extra points for headcounts and the size of budgets:

> The bulk of their compensation - and the potentially enormous upside - is the long-term value of the company. The wrong kind of compensation practice can cause misalignment in two ways: (1) by rewarding short-term goals at the expense of long-term value creation, and (2) by rewarding the achievement of localized departmental milestones whether or not they benefit the company as a whole.
>
> [Location: 469]

I am optimistic that Andy Jassy can do as well succeeding Jeff Bezos as Tim Cook has done succeeding Steve Jobs at Apple (AAPL). The 4 keys to Amazon's culture are sure to remain: customer obsession, invention, operational excellence, and long-term thinking.

First-party ("1P") sales are those where Amazon retails its own private-label products or sources products wholesale from a vendor or manufacturer. Third-party ("3P") sales are sales by independent merchants who sell through the Amazon marketplace.

Strong Numbers And Guidance

Looking at the 1Q21 earnings release, the 44% year-over-year growth in 1P revenue from $36.7 billion in 1Q20 to $52.9 billion in 1Q21 is outstanding. Even more impressive is the 64% year-over-year growth in 3P revenue from $14.48 billion in 1Q20 to $23.71 billion. Most amazing of all is the 77% year-over-year growth in other/advertising revenue from $3.9 billion in 1Q20 to $6.9 billion in 1Q21.

The guidance for 2Q21 says net sales should be 24% to 30% higher than 2Q20 and this is a strong indicator that shoppers are sticking with Amazon as things open up. Another good sign for e-commerce is the feedback from the 1Q21 Shopify call regarding New Zealand and Australia. Both countries have started opening up post-pandemic and Shopify has not seen a slowdown.

Sum Of The Parts

Given the different economics in each segment, I like to use a sum of the parts valuation. The year-over-year growth from 1Q20 to 1Q21 is extraordinary for every segment except physical stores:

AMAZON.COM, INC.
Supplemental Financial Information and Business Metrics
(in millions, except employee data)
(unaudited)

	Q4 2019	Q1 2020	Q2 2020	Q3 2020	Q4 2020	Q1 2021	Y/Y % Change
Net Sales							
Online stores (1)	$45,657	$36,652	$45,896	$ 48,350	$ 66,451	$ 52,901	44 %
Online stores -- Y/Y growth, excluding F/X	15 %	25 %	49 %	37 %	43 %	41 %	N/A
Physical stores (2)	$ 4,363	$ 4,640	$ 3,774	$ 3,788	$ 4,022	$ 3,920	(16)%
Physical stores -- Y/Y growth, excluding F/X	(1)%	8 %	(13)%	(10)%	(7)%	(16)%	N/A
Third-party seller services (3)	$17,446	$14,479	$18,195	$ 20,436	$ 27,327	$ 23,709	64 %
Third-party seller services -- Y/Y growth, excluding F/X	31 %	31 %	53 %	53 %	54 %	60 %	N/A
Subscription services (4)	$ 5,235	$ 5,556	$ 6,018	$ 6,572	$ 7,061	$ 7,580	36 %
Subscription services -- Y/Y growth, excluding F/X	32 %	29 %	30 %	32 %	34 %	34 %	N/A
AWS	$ 9,954	$10,219	$10,808	$ 11,601	$ 12,742	$ 13,503	32 %
AWS -- Y/Y growth, excluding F/X	34 %	33 %	29 %	29 %	28 %	32 %	N/A
Other (5)	$ 4,782	$ 3,906	$ 4,221	$ 5,398	$ 7,952	$ 6,905	77 %
Other -- Y/Y growth, excluding F/X	41 %	44 %	41 %	49 %	64 %	73 %	N/A

Image Source: 1Q21 earnings release

1P, Physical Stores, And Subscription

Amazon 1P is growing much faster than Walmart (WMT), Target (TGT) and Costco (COST):

Image Source: author's spreadsheet based on 10-Ks

Fiscal year-end dates above for Costco, Amazon, Walmart and Target are the Sunday closest to August 31st, December 31st, January 31st and the Saturday nearest January 31st, respectively.

Unlike Costco where they make much of their profit from membership fees, Amazon loses money on Prime per the October 2020 Investigation of Competition in Digital Markets Report:

> Despite Amazon Prime's popularity and wide membership base, it is a loss-leader for the company. Many industry analysts have estimated Amazon's Prime losses over the years, finding that it is unprofitable, and that Amazon is willing to spend significant amounts of money to prop up the program. In 2016, a Forrester Research analysis estimated that Prime costs Amazon $1 billion per year. In 2019, J.P. Morgan estimated that, though priced at $119, a Prime subscription is valued at about $860, up 10% from its estimated value in 2018. A Prime membership also includes access to Prime Video, its library of digital video content, and Amazon Music, its music streaming service. Although Amazon Prime is a loss leader for the company, it is one of Amazon's most effective drivers of growth. Amazon Prime members account for 65% of Amazon shoppers as of Q4 2019. While the average Amazon customer spends about $600 per year on Amazon.com, Prime members reportedly spend more than double that—an average of $1400 per year.

Per their 10-K through January 31st, Walmart had 2,817,071,695 shares of common stock outstanding as of March 17th. Using the May 4th share price of $140.72, we get a market cap of $396.4 billion. Walmart's enterprise value of $448.6 billion is $52.2 billion higher than their market cap due to $58 billion in long-term debt and leases plus $5.3 billion in short-term debt and leases plus $6.6 billion minority interests less $17.7 billion cash and equivalents. Given their respective revenues and the fact that Amazon 1P is growing much faster than Walmart, I think it is reasonable to value these Amazon segments at about half to 2/3rds of Walmart's enterprise value, or about $225 billion to $300 billion.

3P

The FBA program is sticky and the revenue from this area is dependable. Ostensibly, sellers can get the Prime badge by qualifying for Amazon's Seller Fulfilled Prime ("SFP") program or by using fulfillment by Amazon ("FBA"). The October 2020 Investigation of Competition in Digital Markets Report says the reality is that changes to SFP in August 2020 made it impractical for most sellers such that FBA is the only practical path for the Prime badge. The report goes on to say that 75% of Prime customers specifically search for products flagged as Prime-eligible such that merchants without Prime are dead. Further, the report reasons that since FBA is effectively the only way to get the Prime badge, Amazon favors sellers who use FBA over those who do not for both their search rankings and the Buy Box. The 2020 shareholder letter reveals there are 200 million Prime members and Marketplace Pulse shows the FBA/Prime percentage of merchants is over 80%.

The Prime search filter is shown below in the red rectangle:

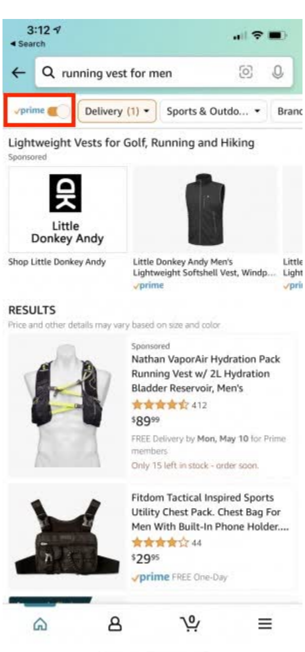

Image Source: Amazon app

Obviously the October 2020 Investigation of Competition in Digital Markets Report is right about the fact that FBA revenue is sticky. However, I think much of their talk about negative aspects of FBA is tenuous. They cite some examples where FBA has been problematic and they quote a competing marketplace company as saying Amazon is using anticompetitive strategies in bundling FBA with their marketplace. It's not surprising that a competitor would be critical and I'm skeptical of the narrative. Many of the authors I've read have more praise than criticism with respect to the way FBA helps merchants.

Working Backwards: Insights, Stories, and Secrets from Inside Amazon says that 3P sellers loved FBA when it launched back in September 2006 as it turned warehousing into a variable cost for them instead of a fixed cost. Having careers at Amazon, the book's authors are biased but that doesn't make them wrong. *The Amazon Jungle* author, Rick Cesari, has been a successful 3P seller and he says the best way to store, pick, pack and ship on Amazon is with FBA. He notes that the costs are far outweighed by benefits like the Prime Badge which can boost sales as much as 30%. In his experience, when shipping from his own warehouse, the outbound shipping costs by themselves without the pick and pack fees were the same price as the all-inclusive FBA fees. His praise of FBA in *The Amazon Jungle* is abundant:

> FBA gives you scalability. When your product lands and you go from selling one a day to 1,000, Amazon can accommodate that higher daily volume without you having to hire staff or find a larger warehouse space. Fulfillment by Amazon is a big reason why Amazon won e-commerce. While I strongly recommend FBA for even the most experienced Amazon Sellers, there is also no better way for new Amazon Sellers to get started. Besides becoming your fulfillment center, there are a number of additional advantages, including low cost, especially for smaller-packaged items. Through FBA, Amazon fully supports your growth and handles some of the customer service issues, like returns.
>
> [Location: 1,829]

Marketplace Pulse shows that 3P gross merchandise volume ("GMV") is growing much faster than 1P GMV:

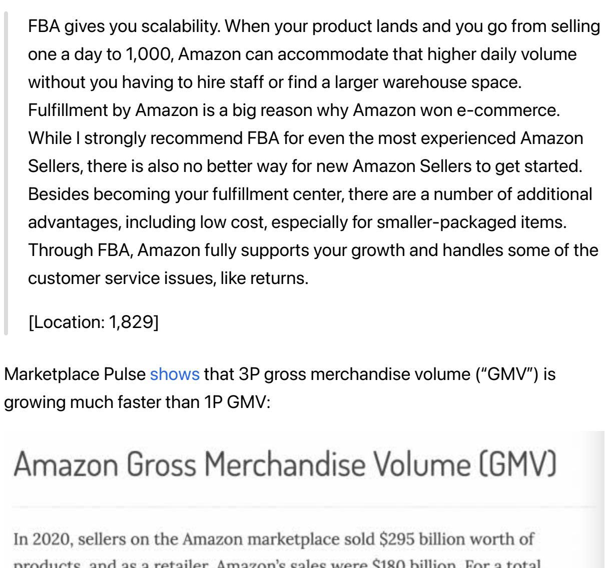

Image Source: Marketplace Pulse

The 2020 shareholder letter says that 3P merchants had cumulative profits in the range of $25 billion to $39 billion during the year.

The trailing-twelve-month ("TTM") revenue for the 3P segment is nearly $90 billion. In October 2018, the WSJ said the following about 3P margins:

> Third-party sales are more profitable than Amazon's typical retail sales as they don't involve inventory and other related charges. Brian Nowak of Morgan Stanley estimates about 20% margins on earnings before interest, taxes, depreciation and amortization for Amazon's third-party transactions compared to less than 5% for typical retail sales.

Jason Goldberg said the following about 3P margins in a January 2020 podcast:

> It's totally viable that this looks like a better profitability business than AWS.

Given the fact that 3P has higher growth, higher GMV and higher profit margins than 1P, I think it is easily worth 2 to 2.5 times the midpoint of my 1P, Physical Stores And Subscription valuation range. I value this segment at about $525 billion to $656 billion.

Other/Advertising

Per the 1Q21 call, advertising revenue accelerated during the quarter:

> In addition to our strong segment results, advertising revenue within the North America and international segments also accelerated during the quarter.

Amazon 3P merchants are heavily incentivized to use the advertising ecosystem. The October 2020 Investigation of Competition in Digital Markets Report says that a recent survey showed that among large brands in the Amazon marketplace, at least 73% of them used Amazon's advertising service and at least 65% spent $40,000 or more per month on it.

The Amazon Jungle explains why 3P merchants are incentivized to use the advertising ecosystem. Feeding the Amazon algorithm is the key to high 3P merchant sales. Part of this feeding process is to start with low prices for a new product as the prices can gradually be raised over time. Ads are another part of the feeding process which is why the advertising segment is sticky. The book recommends spending as much as 100% of the sales amount on Sponsored Ads for the first 30 days after a product is launched:

> Good ad placement helps your product get seen and get sales, and because Amazon's algorithm likes sales more than anything else, it rewards you with better placement. When a paid keyword ad converts to a sale for your listing, the search algorithm adds relevance, and it links that keyword to your product. If you get enough sales driven by that keyword, then Amazon's search ranking algorithm will not only give your ads better placement for less money, it will also help your product rank in the organic search results. Organic rank is important because those clicks are free and the more organic sales a Seller gets, the more that Seller can afford to buy more ads, which doubles their presence on search results. If you can rank high on the Page 1 with an organic link and a sponsored link, then you've just doubled your chances of getting the click.
>
> [Location: 1,884]

Excluding F/X, the other/advertising sales grew 77% from $3.9 billion in 1Q20 to $6.9 billion in 1Q21. TTM sales for this segment are $24.5 billion. Given the high growth and the excellent margins in this segment, I think it is worth about 15 to 16 times sales or $368 billion to $392 billion.

AWS

Per the 1Q21 earnings release numbers below, AWS is a $54 billion run rate business with Y/Y sales growth of 32% and a 1Q21 quarterly operating margin of 30.8%. The TTM growth in both sales and operating income has been prodigious and the TTM operating margin has been near 30% the last 3 quarters:

AMAZON.COM, INC.
Supplemental Financial Information and Business Metrics
(in millions)
(unaudited)

	Q4 2019	Q1 2020	Q2 2020	Q3 2020	Q4 2020	Q1 2021	Y/Y % Change
Segments							
North America Segment:							
Net sales	$ 53,670	$ 46,127	$ 55,436	$ 59,373	$ 75,346	$ 64,366	40 %

Net sales -- Y/Y growth, excluding F/X	22 %	29 %	44 %	39 %	40 %	39 %	N/A
Net sales -- TTM	$170,773	$181,088	$197,871	$214,606	$236,282	$254,521	41 %
Operating income	$ 1,900	$ 1,312	$ 2,141	$ 2,252	$ 2,946	$ 3,450	163 %
F/X impact -- favorable (unfavorable)	$ (3)	$ 5	$ (4)	$ —	$ 7	$ 8	N/A
Operating income -- Y/Y growth (decline), excluding F/X	(16)%	(43)%	37 %	76 %	55 %	162 %	N/A
Operating margin -- % of North America net sales	3.5 %	2.8 %	3.9 %	3.8 %	3.9 %	5.4 %	N/A
Operating income -- TTM	$ 7,033	$ 6,057	$ 6,634	$ 7,604	$ 8,651	$ 10,789	78 %
Operating margin -- TTM % of North America net sales	4.1 %	3.4 %	3.4 %	3.5 %	3.7 %	4.2 %	N/A
International Segment:							
Net sales	$ 23,813	$ 19,106	$ 22,668	$ 25,171	$ 37,467	$ 30,649	60 %
Net sales -- Y/Y growth, excluding F/X	15 %	20 %	41 %	33 %	50 %	50 %	N/A
Net sales -- TTM	$ 74,723	$ 77,637	$ 83,935	$ 90,758	$104,412	$115,955	49 %
Operating income (loss)	$ (617)	$ (398)	$ 345	$ 407	$ 363	$ 1,252	N/A
F/X impact -- favorable (unfavorable)	$ (7)	$ (5)	$ 32	$ 152	$ 232	$ 270	N/A
Operating income/loss -- Y/Y growth (decline), excluding F/X	(5)%	338 %	N/A	N/A	N/A	347 %	N/A
Operating margin -- % of International net sales	(2.6)%	(2.1)%	1.5 %	1.6 %	1.0 %	4.1 %	N/A
Operating income (loss) -- TTM	$ (1,693)	$ (2,001)	$ (1,055)	$ (262)	$ 717	$ 2,367	N/A
Operating margin -- TTM % of International net sales	(2.3)%	(2.6)%	(1.3)%	(0.3)%	0.7 %	2.0 %	N/A
AWS Segment:							
Net sales	$ 9,954	$ 10,219	$ 10,808	$ 11,601	$ 12,742	$ 13,503	32 %
Net sales -- Y/Y growth, excluding F/X	34 %	33 %	29 %	29 %	28 %	32 %	N/A
Net sales -- TTM	$ 35,026	$ 37,549	$ 39,976	$ 42,582	$ 45,370	$ 48,654	30 %
Operating income	$ 2,596	$ 3,075	$ 3,357	$ 3,535	$ 3,564	$ 4,163	35 %
F/X impact -- favorable (unfavorable)	$ 26	$ 63	$ 83	$ (20)	$ (96)	$ (171)	N/A
Operating income -- Y/Y growth, excluding F/X	18 %	36 %	54 %	57 %	41 %	41 %	N/A
Operating margin -- % of AWS net sales	26.1 %	30.1 %	31.1 %	30.5 %	28.0 %	30.8 %	N/A
Operating income -- TTM	$ 9,201	$ 10,053	$ 11,289	$ 12,563	$ 13,531	$ 14,619	45 %
Operating margin -- TTM % of AWS net sales	26.3 %	26.8 %	28.2 %	29.5 %	29.8 %	30.0 %	N/A

Image Source: 1Q21 earnings release

I think AWS is easily worth 10 or 11 times the $54 billion net sales run rate implying a value of $540 billion to $594 billion:

Opaque Considerations

The October 2020 Investigation of Competition in Digital Markets Report notes that Amazon's delivery service is growing robustly:

> Parcel volume handled by Amazon's delivery service now rivals the top carriers, including UPS, FedEx, and the U.S. Postal Service. "In 2019, Amazon delivered 2.5 billion parcels, or about one-fifth of all e-commerce deliveries," and anticipates growth. In a July 2020 investor call, Amazon CFO Brian Olsavsky stated that Amazon "expect[s] a meaningfully higher year-over-year square footage growth of approximately 50%," which includes "strong growth in new fulfillment center space as well as sort centers and delivery stations." An analysis by Morgan Stanley concluded that Amazon will overtake UPS and FedEx in market share for delivery by 2022. Amazon has already surpassed the U.S. Postal Service, which has been downsized dramatically under its current leadership.

Many speculate that Amazon Logistics ("AMZL") could soon offer significant shipping services to merchants outside of the Amazon marketplace.

There are several ways in which Amazon could move into healthcare. The amazon.care website is intriguing:

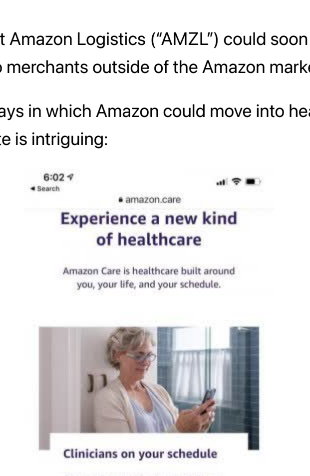

Image Source: amazon.care

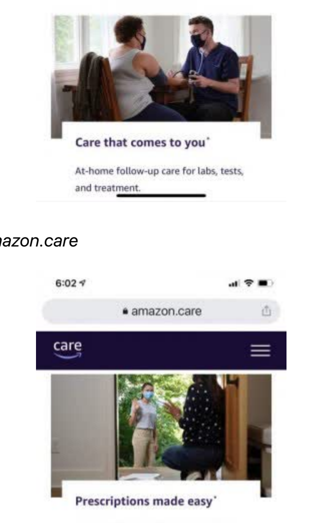

Image Source: amazon.care

In the same way that the AWS business was created without competitors catching on, Amazon could be creating other new businesses involving logistics, healthcare and other possibilities. Given the fact that invention is one of the key parts of Amazon's culture, I would be surprised if they don't introduce some new businesses in the next few years. I put a value of $100 billion to $150 billion on these opaque considerations.

Valuation Summary

$225 to $300 billion 1P, physical stores and subscription

$525 to $656 billion 3P

$368 to $392 billion other/advertising

$540 to $594 billion AWS

$100 to $150 billion opaque considerations

$1,758 to $2,092 billion

There were 504,323,736 shares of common stock as of April 21st. Looking at the May 4th share price of $3,311.87, the market cap is $1,670.3 billion. The enterprise value of $1,682 billion is $11.7 billion more than the market cap due to $31.8 billion long-term debt plus $53.1 billion long-term leases less $33.8 billion cash and equivalents less $39.4 billion marketable securities.

Seeing as my valuation range is above the current enterprise value, I think the stock is reasonably priced as a long-term investment.

Disclaimer: Any material in this article should not be relied on as a formal investment recommendation. Never buy a stock without doing your own thorough research.

This article was written by

Eric Sprague Follow
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I'm an individual investor heavily influenced by Warren Buffett and Charlie Munger. Munger's 1994 USC Busin... more

Disclosure: I am/we are long AMZN, AAPL, SHOP, VOO. I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it (other than from Seeking Alpha). I have no business relationship with any company whose stock is mentioned in this article.

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Comments (22)

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Publish

khlim115
Premium Marketplace Comments (1.48K) | + Follow
Yesterday, 4:30 PM

It seems everyone is cashing in whatever profit they can. Chart suggests it is near a solid short term support. Lets see if it holds.

Reply Like (2)

kevn1111
Marketplace Comments (4.93K) | + Follow
Yesterday, 3:32 PM

Price action is not shining. Getting dimmer as it keeps sinking down the well.

Reply Like

freshcupajoe
Comments (1.53K) | + Follow
Yesterday, 2:38 PM

The price action on Amazon is among the worst I've ever seen. It looks like it wants to drill to $3,000 again. Algorithms control the market now. The stock will only go up when the cycle changes which could be months more of sideways to down action. Splitting the stock would help, but management is vehemently opposed to it at this point. It is what it is

Reply Like (1)

wdchil
Comments (4.78K) | + Follow
Yesterday, 12:14 PM

Great article! One takeaway I get - AMZN is all about synergy between different offerings. On the consumer side, Prime ties together retail, video, and music. On the business side there is a synergy between 3P sales and advertising. The rapid growth in the higher margin businesses suggest that cash flow will grow much faster than revenue over the next 5 years. At the same time, the need for huge investment may decrease, although I wonder what the investment in fulfillment will be in foreign markets. That is a huge capital requirement for both Amazon and Walmart these days - and it is difficult for any other company to replicate. Long big tech (FAAMG) and WMT. WD *(edited)*

Reply Like

Eric Sprague
Contributor Premium Comments (942) | + Follow
Yesterday, 2:42 PM

Author's Reply Thanks, @wdchil! Like you said, the synergy between 3P sales and advertising is noteworthy.

Reply Like

Gpa Bui
Comments (31) | + Follow
Yesterday, 11:35 AM

Lately, I noted the prices (of same items) on amzn are much higher than the competitors.
Therefore, I am doing much more searches than before to save money.
I think, this will hurt amzn sales.

Reply Like

Gary J is Rich on AMZN
Comments (28.54K) | + Follow
Yesterday, 12:00 PM

@Gpa Bui

Nope. 200 million Prime members put price down the priority list to customer service, item choice, convenience, 1 click and done, 5% off with Amazon Chase Visa, on and on.

Reply Like (2)

Eric Sprague
Contributor Premium Comments (942) | + Follow
Yesterday, 2:43 PM

Author's Reply @Gary J is Rich on AMZN Yeah, I guess it depends on the buyer. For me Amazon is close enough to having the best price that I don't think much about it.

Reply Like (3)

chakd
Comments (193) | + Follow
Yesterday, 2:58 PM

@Gpa Bui Amazon is shown to be the lowest overall in prices chainstoreage.com/...

Reply Like (3)

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ATLAtty
Premium Comments (493) | + Follow
Yesterday, 9:30 AM

People under 30 do not know what a mall is.

Reply Like (1)

Buyandhold 2012
Marketplace Comments (30.5K) | + Follow
Yesterday, 7:56 AM

We shop differently?

I don't shop any differently than I did 50 years ago.

I walk into a store, look around, and if I find something that I like, I buy it and pay for it with my MasterCard.

I hardly ever shop online. I think I once bought two movies from Amazon online. So long ago they were VHS.

When I need to buy airline tickets, I have my son do it for me to avoid having to shop online.

These kids today are tech savvy. They know how to text. They can even use mobile apps.

Reply Like (1)

Bill West
Comments (530) | + Follow
Yesterday, 8:56 AM

@Buyandhold 2012
So striving to be a Luddite is a good quality?!
Once you get the online click pay deliver to your door synergies going in your life you will never look back......

I guess you still have that Kenner Close and Play Phonograph too??

Reply Like (5)

Gary J is Rich on AMZN
Comments (28.54K) | + Follow
Yesterday, 9:38 AM

@Bill West

LOL some are stuck in the last century. Better them than us.

Reply Like (2)

Buyandhold 2012
Marketplace Comments (30.5K) | + Follow
Yesterday, 10:45 AM

@Bill West

No.

I have an old Victrola.

Reply Like (1)

See More Replies

Gary J is Rich on AMZN
Comments (28.54K) | + Follow
Yesterday, 7:06 AM

You covered it all. So many articles do not even mention the key word at all - the ecosystem called PRIME.

Reply Like (3)

Eric Sprague
Contributor Premium Comments (942) | + Follow
Yesterday, 9:38 AM

Author's Reply Thanks, @Gary J is Rich on AMZN! Yeah, Prime is a game changer!

Reply Like (1)

BAHAMAS1
Comments (8.34K) | + Follow
Yesterday, 6:44 AM

Thanks for the article and all the work you put into it.

AMZN, at the closing stock price on 4 May 2021 of $3311.87, is damn cheap...imo.

Long AMZN

Reply Like (5)

Eric Sprague
Contributor Premium Comments (942) | + Follow
Yesterday, 9:37 AM

Author's Reply Thanks, @BAHAMAS1! Yeah, given their recent segment numbers the price looks attractive.

Reply Like (1)

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